2017

The Practical Application of the United States Accounting Codification

Parker Durham
University of Mississippi. Sally McDonnell Barksdale Honors College

THE PRACTICAL APPLICATION OF THE UNITED STATES ACCOUNTING CODIFICATION

by
Austin Parker Durham

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
May 2017

Approved by

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Advisor: Dr. Victoria Dickinson

ABSTRACT

The United States Accounting Standards Codification is the source of the Generally Accepted Accounting Principles, or GAAP, that all publically traded U.S. companies and many private companies adhere to. This thesis concerns the United States Accounting Codification and how it is applied to real-life scenarios derived from various business activities. These different scenarios were provided by Dr. Victoria Dickinson in a series of twelve different case studies and covered numerous areas of financial reporting. This thesis is the compilation of the solutions to those case studies and has been verified to be in accordance with Generally Accepted Accounting Principles.

Numerous benefits were realized upon completion of every case study. These include enhanced knowledge of financial reporting topics, technical skills, theoretical concepts, exceptional research processing ability, and a critical thinking approach to constructing solutions to contextualized problems. A different financial reporting topic was chosen each week, with the difficulty increasing as more knowledge was gained regarding the Codification and GAAP. These topics include financial statement preparation and consultation, systems evaluation and fraud prevention, inventory recognition, asset capitalization, accounting for termination benefits and relocation costs, market shares and treasury stock, stock options and stock-based compensation, revenue recognition, deferred tax assets and liabilities, and accounting for lease transactions. Mastering these topics mandated also the mastery of technical skills such as the infinite uses of Microsoft Excel and Word.

Without these, financial statement preparation or analysis would be near impossible. Perhaps the most beneficial skill and ability acquired during these case studies was the ability to take a critical thinking approach to a real-life case where an obvious answer was not immediately transparent. This included contextualizing the problem in the case, knowing the accounting area that applied to the problem, and having the ability to research the U.S. Accounting Codification to find which accounting principle applied depending on the scenario.

The knowledge and skills gained from these case studies will be invaluable in my future career as a public accountant. While I still have much to learn, the experience acquired in this course left me with not only tangible skills, but also the confidence of knowing that this course has prepared me well for challenges or problems I may face in my professional career. Interning at a large firm immediately following graduation, I know that this course will give me a distinct advantage over my colleagues that have not taken the course and completed these case studies.

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Case 1:

Glenwood Heating, Inc. and Eads Heater Inc.

Executive Summary:
The following document provides the financial statements of Glenwood Heating, Inc. and Eads Heater, Inc. Also included are the journal entries made by both companies throughout the year. These entries can be found in Appendix A and B, respectively. Provided below is the author's opinion on the state and strength of the two companies.

Author's Analysis:
As most of the transactions of these two companies are identical, there is little difference between the two. In fact, the differences that do occur are primarily caused not by an operating advantage, but by the difference of preferred accounting treatment and estimates between the two companies. For example, while Glenwood Heating, Inc. has a more attractive earnings per share ratio, a more in-depth look into the financial statements show that this is caused primarily by the increased depreciation expense incurred by Eads Heater, Inc. While Glenwood Heating looks more profitable at first glance, an argument could be made that Eads Heater, who signed a capital lease on its equipment, has the advantage if Glenwood Heating's rent expense unexpectedly increases.

Glenwood Heating, Inc.
Income Statement
For the Year Ended December 31, 20X1

Sales	$398,500.00
Cost of Goods Sold	$177,000.00
Gross Profit	$221,500.00
Operating Expenses	
Bad Debt Expense	$994.00
Depreciation Expense	$19,000.00
Other Operating Expenses	$34,200.00
Rent Expense	$16,000.00
Income from Operations	$151,306.00
Other Expenses and Losses	
Interest Expense	$27,650.00
Income from Continuing Operations Before Tax	$123,656.00
Income Tax Expense	$30,914.00
Net Income	$92,742.00
EPS	$28.98

Glenwood Heating, Inc.
Statement of Changes in Stockholder Equity
For the Year Ended December 31, 20X1

Beginning Stockholder Equity		$160,000.00
Net Income	$92,742.00	
Less: Dividends	$23,200.00	
Net Change in Stockholder Equity		$69,542.00
Ending Stockholder Equity		$229,542.00

Glenwood Heating, Inc.
Classified Balance Sheet
December 31, 20X1

Assets			
Current Assets			
Cash		$426.00	
Accounts Receivable	$99,400.00		
Less: Allowance for Bad Debts	$994.00	$98,406.00	
Inventory		$62,800.00	
Total Current Assets		$161,632.00	
Property, Plant, & Equipment			
Land		$70,000.00	
Building	$350,000.00		
Less: Accumulated Depreciation, Building	$10,000.00	$340,000.00	
Equipment	$80,000.00		
Less: Accumulated Depreciation, Equipment	$9,000.00	$71,000.00	
Total Property, Plant, & Equipment		$481,000.00	
Total Assets			$642,632.00
Liabilities and Stockholder Equity			
Current Liabilities			
Accounts Payable		$26,440.00	
Interest Payable		$6,650.00	
Total Current Liabilities		$33,090.00	
Long Term Liabilities			
Notes Payable		$380,000.00	
Total Liabilities			$413,090.00
Stockholder Equity			
Common Stock		$160,000.00	
Retained Earnings		$69,542.00	
Total Stockholder Equity			$229,542.00
Total Liabilities and Stockholder Equity			$642,632.00

Glenwood Heating, Inc.
Statement of Cash Flows
For the Year Ended December 31, 20X1

Cash Flow from Operating Activities		
Net Income		$92,742.00
Adjustments to reconcile Net Income to Cash		
Accounts Receivable	$(99,400.00)	
Inventory	$(62,800.00)	
Accounts Payable	$26,440.00	
Interest Payable	$6,650.00	
Bad Debt Expense	$994.00	
Depreciation Expense	$19,000.00	$(109,116.00)
Net Cash Flows from Operating Activities		$(16,374.00)
Cash Flow from Investing Activities		
Land Acquired		$(70,000.00)
Building Acquired		$(350,000.00)
Equipment Acquired		$(80,000.00)
Net Cash Flow from Investing Activities		$(500,000.00)
Cash Flow from Financing Activities		
Issuance of Note Payable		$380,000.00
Issuance of Common Stock		$160,000.00
Payment of Dividend		$(23,200.00)
Net Cash Flow from Financing Activities		$516,800.00
Total Net Cash Flows		$426.00

Eads Heater, Inc.
Income Statement
For the Year Ended December 31, 20X1

Sales	$398,500.00
Cost of Goods Sold	$188,800.00
Gross Profit	$209,700.00
Operating Expenses	
Bad Debt Expense	$4,970.00
Depreciation Expense	$41,500.00
Other Operating Expenses	$34,200.00
Income from Operations	$129,030.00
Other Expenses and Losses	
Interest Expense	$35,010.00
Income from Continuing Operations Before Tax	$94,020.00
Income Tax Expense	$23,505.00
Net Income	$70,515.00
EPS	$22.04

Eads Heater, Inc.
Statement of Changes in Stockholder Equity
For the Year Ended December 31, 20X1

Beginning Stockholder Equity		$160,000.00
Net Income	$70,515.00	
Less: Dividends	$23,200.00	
Net Change in Stockholder Equity		$47,315.00
Ending Stockholder Equity		$207,315.00

Eads Heater, Inc.
Classified Balance Sheet
December 31, 20X1

Assets			
Current Assets			
Cash		$7,835.00	
Accounts Receivable	$99,400.00		
Less: Allowance for Bad Debts	$4,970.00	$94,430.00	
Inventory		$51,000.00	
Total Current Assets		$153,265.00	
Property, Plant, & Equipment			
Land		$70,000.00	
Building	$350,000.00		
Less: Accumulated Depreciation, Building	$10,000.00	$340,000.00	
Equipment	$80,000.00		
Less: Accumulated Depreciation, Equipment	$20,000.00	$60,000.00	
Leased Equipment	$92,000.00		
Less: Accumulated Depreciation, Leased Equipment	$11,500.00	$80,500.00	
Total Property, Plant, & Equipment		$550,500.00	
Total Assets			$703,765.00
Liabilities and Stockholder Equity			
Current Liabilities			
Accounts Payable		$26,440.00	
Interest Payable		$6,650.00	
Total Current Liabilities		$33,090.00	
Long Term Liabilities			
Notes Payable		$380,000.00	
Lease Payable		$83,360.00	
Total Liabilities			$496,450.00
Stockholder Equity			
Common Stock		$160,000.00	
Retained Earnings		$47,315.00	
Total Stockholder Equity			$207,315.00
Total Liabilities and Stockholder Equity			$703,765.00

Eads Heater, Inc.
Statement of Cash Flows
For the Year Ended December 31, 20X1

Cash Flow from Operating Activities		
Net Income		$70,515.00
Adjustments to reconcile Net Income to Cash		
Accounts Receivable	$(99,400.00)	
Inventory	$(51,000.00)	
Accounts Payable	$26,440.00	
Interest Payable	$6,650.00	
Bad Debt Expense	$4,970.00	
Depreciation Expense	$41,500.00	$(70,840.00)
Net Cash Flows from Operating Activities		$(325.00)
Cash Flow from Investing Activities		
Land Acquired		$(70,000.00)
Building Acquired		$(350,000.00)
Equipment Acquired		$(70,000.00)
Net Cash Flow from Investing Activities		$(500,000.00)
Cash Flow from Financing Activities		
Issuance of Note Payable		$380,000.00
Issuance of Common Stock		$160,000.00
Payment of Dividend		$(23,200.00)
Payment of Lease		$(8,640.00)
Net Cash Flow from Financing Activities		$508,160.00
Total Net Cash Flows		$7,835.00

Appendix A: Transactions of Glenwood Heating, Inc.

Transaction #	Cash	A/R	Allowance for Bad Debts	Inventory
1	160000			
2	400000			
3	-420000			
4	-80000			
5				239800
6		398500		
7	299100	-299100		
8	-213360			
9	-41000			
10	-34,200			
11	-23,200			
12				
Totals	47340	99400	0	239800
13			994	
14				-177000
15				
16	-16000			
17	-30914			
Adjustments	-46914	0	994	-177000
Adjusted Totals	426	99400	994	62800

Land	Building	Acc. Dep. Building	Equipment
70000	350000		
			80000
70000	350000	0	80000
		10000	
0	0	10000	0
70000	350000	10000	80000

Int. Pay.	N/P	Lease Pay.	C/S	R/E	Dividends
			160000		
	400000				
	-20000				
					23,200
6650					
6650	380000	0	160000	0	23200
0	0	0	0	0	0
6650	380000	0	160000	0	23200

Acc. Dep. Equipment	Leased Equipment	Acc. Dep. Leased Eq.	A/P
			239800
			-213360
0	0	0	26440
9000			
9000	0	0	0
9000	0	0	26440

Dep. Exp.	Int. Exp.	Other Op. Exp	Rent Exp.	Provision for income taxes
	21000			
		34200		
	6650			
0	27650	34200	0	0
19000				
			16000	
				30,914
19000	0	0	16000	30914
19000	27650	34200	16000	30914

Sales	CGS	Bad debt Exp.
398500		
398500	0	0
		994
	177000	
0	177000	994
398500	177000	994

Appendix B: Transactions of Eads Heater, Inc.

Transaction #	Cash	A/R	Allowance for Bad Debts	Inventory	Land	Building	Acc. Dep. Bu	Equipment
1	160000							
2	400000							
3	-420000				70000	350000		
4	-80000							80000
5				239800				
6		398500						
7	299100	-299100						
8	-213360							
9	-41000							
10	-34,200							
11	-23,200							
12								
Totals	47340	99400	0	239800	70000	350000	0	80000
13			4970					
14				-188800				
15							10000	
16a.								
16b.	-16000							
16c.								
17	-23,505							
Adjustments	-39505	0	4970	-188800	0	0	10000	0
Adjusted Total	7835	99400	4970	51000	70000	350000	10000	80000

Acc. Dep. Equipment	Leased Equipm	Acc. Dep. Lease	A/P	Int. Pay.
			239800	
			-213360	
				6650
0	0	0	26440	6650
20000				
	92000			
		11500		
20000	92000	11500	0	0
20000	92000	11500	26440	6650

N/P	Lease Pay.	C/S	R/E
		160000	
400000			
-20000			
380000	0	160000	0
	92000		
	-8640		
0	83360	0	0
380000	83360	160000	0

Dep. Exp.	Int. Exp.	Other Op. Ex	Rent Exp.	Provision for income taxes
	21000			
		34200		
	6650			
0	27650	34200	0	0
30000				
	7360			
11500				
				23505
41500	7360	0	0	23505
41500	35010	34200	0	23505

Dividends	Sales	CGS	Bad debt Exp.
	398500		
23,200			
23200	398500	0	0
			4970
		188800	
0	0	188800	4970
23200	398500	188800	4970

Case 2:

Totz, Inc.

To whom it may concern at Totz, Inc.:

Thank you for contracting Parker Durham Consulting Services with your business. We are excited to help you with any questions you might have in regards to preparing your income statement for the fiscal year ended January 30, 2016. Below you will find our opinions numbered that correspond directly with the information you provided us.

A) With regards to your sales presentation, because you have two different revenue streams; one deriving from manufacturing and retail, and the other deriving from services, you should look at SEC § 210.5–03.1, as well as FASB code 225-10-S99. This section of the codification states that revenues derived from the net sales of tangible products and the revenues derived from provided services should be stated in two separate line items. Adhering to this, you should report sales from retail of \$75.3 million and sales from services of \$11.2 million.

B) In accordance with SEC § 210.5–03.2 and FASB 225-10-S99, you should also present as separate line items the cost of tangible goods sold and the cost of services. It appears that you included the direct labor costs for your Doodlez employees in your gross profit calculation, and this is incorrect, as only the cost of the tangible goods sold should be used in gross profit calculation.

C) In accordance with SEC § 210.5–03.7(d) and FASB 225-10-S99, you should report your \$1.7 million gain as a separate line item under “non-operating income.”

D) As we consider this class action lawsuit both unusual and infrequent, we believe it constitutes an extraordinary item described in FASB codification 225-20-45. This treatment as a separate line item also complies with SEC § 210.5–03.16, which requires that SEC companies list extraordinary gains and losses as separate line items.

Case 3:

Rocky Mountain Chocolate Factory, Inc.

Rocky Mountain Chocolate Factory
Unadjusted Trial Balance
28-Feb-10

	Debit	Credit
Cash and Cash Equivalents	$3,743,092.00	
Accounts Receivable	4,427,526	
Notes Receivable, Current	91,059	
Inventories	3,498,283	
Deferred income taxes	461,249	
Other	220,163	
Property and Equipment, Net	5,885,289	
Notes Receivable, less current portion	263,650	
Goodwill, Net	1,046,944	
Intangible Assets, Net	110,025	
Other	88,050	
Accounts Payable		877,832
Accrued Salaries and Wages		0
Other Accrued Expenses		946,528
Dividend Payable		602,694
Deferred Income		220,938
Deferred income taxes		894,429
Common Stock		180,808
Additional Paid-in-Capital		7,626,602
Retained Earnings		3,343,850
Sales		22,944,017
Franchise and Royalty Fees		5,492,531
Cost of Sales	14,693,786	
Franchise Costs	1,499,477	
Sales and Marketing	1,505,431	
General and Administrative	1,782,947	
Retail Operating	1,750,000	
Depreciation and Amortization	0	
Interest Income		27,210
Income Tax Expense	2,090,468	
Totals	$43,157,439.00	$43,157,439.00

Rocky Mountain Chocolate Factory, Inc.
Income Statement
For the Year Ended February 28, 2010

Revenues		
Sales	$22,944,017.00	
Franchise and Royalty Fees	5,492,531	
Total Revenues		$28,436,548.00
Expenses		
Cost of Sales	14,910,622	
Franchise Costs	1,499,477	
Sales and Marketing	1,505,431	
General and Administrative	2,422,147	
Retail Operating	1,756,956	
Depreciation and Amortization	698,580	
Total Expenses		22,793,213
Operating Income		$5,643,335.00
Other Income and Expenses		
Interest Income	27,210	
Income before Income Taxes		$5,670,545.00
Income Tax Expense	2,090,468	
Net Income		$3,580,077.00

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
28-Feb-10

Assets			
Current Assets			
Cash and Cash Equivalents	$3,743,092.00		
Accounts Receivable	4,427,526		
Notes Receivable, Current	91,059		
Inventories	3,281,447		
Deferred income taxes	461,249		
Other	220,163		
Total Current Assets		$12,224,536.00	
Property, Plant, and Equipment			
Property and Equipment, Net		$5,186,709.00	
Other Assets			
Notes Receivable, less current portion	263,650		
Goodwill, Net	1,046,944		
Intangible Assets, Net	110,025		
Other	88,050		
Total Other Assets		$1,508,669.00	
Total Assets			$18,919,914.00
Liabilities and Owner's Equity			
Current Liabilities			
Accounts Payable	877,832		
Accrued Salaries and Wages	646,156		
Other Accrued Expenses	946,528		
Dividend Payable	602,694		
Deferred Income	220,938		
Total Current Liabilities		$3,294,148.00	
Deferred Income Taxes	894,429		
Total Liabilities		$4,188,577.00	

Rocky Mountain Chocolate Factory, Inc.
Balance Sheet
28-Feb-10

Owner's Equity			
Common Stock	180,808		
Additional Paid-in-Capital	7,626,602		
Retained Earnings	6,923,927		
Total Owner's Equity		$14,731,337.00	
Total Liabilities and Owner's Equity			$18,919,914.00

Rocky Mountain Chocolate Factory, Inc.
Statement of Retained Earnings
For the Year Ended February 28, 2010

Retained Earnings, February 28, 2009		$5,751,017.00
Net Income, 2010	3,580,077	
Less: Dividends	- 2,407,167	
Retained Earnings, February 28, 2010		$6,923,927.00

Case 4

Executive Summary:
Kayla, thank you for hiring Accounting 420 Consulting Group, LLC. We have evaluated your operations and have identified areas where fraud might occur. Along with these identified areas, we have provided our recommendations of internal control that will help eliminate these possibilities of fraud. Please see our recommendations in the table provided below.

Problem Susceptible to Fraud	Recommended Control
Lucy records daily sales and prepares the corresponding bank deposits.	You should implement a segregation of duties so there is a different person recording sales and making bank deposits.
While the automatic update of the perpetual inventory system is efficient, not verifying the physical inventory count to the perpetual inventory count on the books is a problem.	Have another employee conduct a physical inventory count weekly and report any discrepancies between the count and the recorded book value.
Lucy has access to the accounting system, even though she is in charge of making bank deposits.	There should be a segregation of duties so a different person handles the accounting system than the one who makes bank deposits.
While the unique code is a start for preventing unauthorized access to the registers, it is susceptible to theft by another employee.	Add another control measure by requiring employees to swipe a provided employee key card in addition to the unique employee code. Such a control will help prevent unauthorized or fraudulent access to the registers.
You are monitoring the perpetual inventory records and ordering inventory.	Instead of this, have your employee in charge of taking a physical inventory count provide you with the inventory on hand, upon which you order the required inventory needed.
You are taking the deposits to the bank and reconciling the bank statements.	These duties should be separated, as the same person doing both duties opens the door to fraud as well as tainting the independence of the reconciler.
No checks or reconciliations of daily transactions .	While autonomy of the employees is important, you or Lucy should check the validity of every transaction, as well as reconcile the transactions with the cash on hand.

Case 5

A)

The inventory of this company consists of raw materials, work-in-process, and finished good inventories. The raw material inventory makes up approximately 20% of total inventory, with finished goods making up the rest, and work-in-process inventory being immaterial to the total amount. Raw material inventory consists of the cost of the material, as well as the shipping costs to the factory. The finished good inventory consists of the cost of the material, shipping costs to the factory, direct labor, and manufacturing overhead costs the factory has to prepare the goods for sale. A possible explanation for the low work-in-process inventory is that this large manufacturing company's production process is highly automated and efficient, and the low work-in-process inventory is a result of the production machinery being stopped and the residual uncompleted inventory for that day being the amount you see.

B)

Inventory is recorded net of an estimated allowance for obsolete or unmarketable inventory. This allowance is management's best guess as to how much of their finished good products will not be able to be sold.

C)

i) This specific account is a contra account to inventory, and the amount of this account is not directly reported on the balance sheet. Instead, it is subtracted from gross inventory, and the net amount is what is disclosed on the balance sheet.

ii) We know that the beginning balance of the contra account for 2012 is the ending balance of the previous year, 2011. Knowing this, we can arrive at the gross inventory of 2011 by adding back this amount to the net amount reported on the balance sheet. Doing this, we see that gross inventory for 2011 equals $243,870 ($233,070+10,800.) Using this same process, we will add back the ending balance of the contra account for 2012 to net amount reported on the balance sheet to arrive at gross inventory of $224,254 ($211,734+12,520.)

iii) Almost all of the reserve can be attributed to finished goods inventory. This can be attributed to both law of probability, as finished goods inventory makes up 80% of total inventory, and that any obsolete inventory is most likely to be caused by an error in the manufacturing process.

D)

Dr. Cost of Goods Sold	13,348	
Cr. Allowance for Obsolete Inventory		13,348
Dr. Allowance for Obsolete Inventory	11,628	
Cr. Inventory		11,628

E)

Cost of Sales

0	
13,348	
572,549	
585,897	

Finished Goods

184,808	

	13,348
	572,549
568,735	
167,646	

Work-in-Process

1,286	
126,000	
	568,735
442,068	
619	

Raw Materials

46,976	
	442,068
438,561	
43,469	

Accounts Payable

	39,012
	438,561
432,197	
	45,376

i) The cost of finished goods sold during the year was $572,549.

ii) The cost of goods manufactured and transferred from work-in-process was $568,735.

iii) The cost of raw materials transferred to work-in-process during the year was $442,068.

iv) The cost of raw materials purchased during the year was $438,561.

v) The amount cash paid for raw material purchased during the year was $432,197.

F)

The inventory turnover ratio can be calculated by dividing the cost of sales, $585,897, by the average inventories. The average inventory amount is simply the sum of the beginning and ending net inventory divided by two. Doing this, we arrive at average inventory for 2011 and 2012 of $250,830.50 and $222,402, respectively. Dividing both years' cost of sales by these numbers, we are given an inventory turnover ratio for 2011 of 2.2933 and for 2012 of 2.6344.

G)

We can next calculate the inventory-holding period of both years by dividing 365 by these ratios. The holding period was 159.16 days in 2011 and 138.55 days in 2012. By analyzing these calculations, we can see that the company has become more efficient managing its inventory, because they are not having to hold the inventory as long before it is manufactured and sold.

H)

By dividing the allowance for obsolete and unmarketable inventory by finished goods, we can calculate what percentage of finished goods the company estimates to be obsolete. In 2011, the ending balance in the allowance account was $10,800. Dividing this by finished goods inventory, we see that the company estimated that 5.84% (10,800/184,808) of finished goods inventory would be obsolete or unmarketable. Using this same method for 2012, we see that this number increased to 7.47% (12,520/167,646) of finished goods inventory. While at first glance this appears unfavorable, this increase in estimation can be largely attributed to the fact that the company had much less inventory on hand in 2012 than 2011.

As an investor and analyst, I would like the company to provide me with information explaining the sharp decline in sales, despite a better inventory turnover ratio. With improved inventory management, the company should consequently realize higher sales due to greater efficiency. This is not the case, however, and is very concerning for an investor.

Case 6:

WorldCom, Inc.

A.

i) An asset is owned property that has value and helps a company earn money that will enable it to pay off any outstanding obligations. An expense is the cost of something that only brings value for the current period, not in the future.

ii) Dove-tailing off from the above statement, costs should be expensed when they provide an immediate benefit. Costs should be capitalized as assets when they are expected to bring future value to the company.

B.

After an asset is capitalized, it is depreciated every year for the rest of its useful life. This depreciation affects both the income statement and balance sheet. The journal entry to record yearly depreciation is a debit to "depreciation expense" and a credit to "accumulated deprecation." This entry increases the expenses on the income statement, consequently decreasing net income. It also decreases assets, as "accumulated depreciation," a contra-asset account, decreases the net amount of assets shown on the balance sheet.

C.

Line costs in 2001 were $14,739,000,000. The journal entry used to record these expenses is:

dr. Line Costs	$14,739,000,000	
cr. Cash		$14,739,000,000

These line costs include charges paid to local telephone companies to complete calls.

D.

WorldCom improperly capitalized costs paid to local telephone networks to make calls. These charges were made in the current period, with no future benefit expected, and thus does not meet the definition of an asset.

E.

dr. PPE	$3,055,000,000	
cr. Cash		$3,055,000,000

These costs appear on the balance sheet under either transmission or communication equipment, both of which are line items which qualify as long term property, plant, and equipment; and appears on the statement of cash flows under "financing activities."

F.

To calculate depreciation expense, we will divide the capitalized amount by 22 (the midpoint of 4 and 40,) and multiply this number by the fraction of the year of which the capitalized amount was on the balance sheet.

$771,000,000 / 22 * (4/4) = $35,045,454.55

$610,000,000 / 22 * (3/4) = $20,795,454.55

$743,000,000 / 22 * (2/4) = $16,886,363.64

$931,000,000 / 22 * (1/4) = <u>$10,579,545.45</u>

Yearly Depreciation for 2001: $83,306,818.19

Journal Entry to record this depreciation:

dr. Depreciation Expense	$83,306,818.19	
cr. Accumulated Deprecation		$83,306.818.19

G.

Income before taxes, as reported	$2,939,000,000
Add back depreciation for the year from part f	$83,306,818.19
Deduct line costs that were improperly capitalized	($3,055,000,000)
Loss before taxes, restated	($32,693,181.81)
Income Tax Benefit (Loss*35%)	$11,442,613.63
Minority Interest	($319,899,999.80)
Net Lost, Restated	($341,150,568)

The difference in net income is $3,280,150,568 is absolutely material.

Case 7:

Targa Corporation

Introduction:

Targa Corporation prepares its financial statements in accordance with Generally Accepted Accounting Principles (GAAP). Targa is restructuring a business line. As part of the restructuring, the company is considering the relocation of a manufacturing operation from its present location to a new facility in a different geographical area. The relocation plan would include the termination of certain employees.

Specifically, the relocation plan involves the termination of 120-125 employees, which represents approximately 10% of Targa's workforce. On December 27, 20X1, the company communicated a one-time, nonvoluntary termination plan to its employees, which includes ten weeks pay in addition to the standard two weeks severance pay upon termination. The termination benefit, severance pay, and terminated managers' bonus will cost the company $2.5 million, $500 thousand, and $50 thousand, respectively. In addition to these costs, Targa will incur a relocation cost of $500 thousand and a staff training cost of $1.5 million. The workforce reduction is expected to be completed by January 31, 20X2

The following is a professional analysis of how Targa Co. should account for these employee benefits and retraining and relocation costs for the year ended December 31, 20X1.

A) Accounting for Employee Termination Benefit

FASB Codification 420-10-30-6 states:

"Nonretirement postemployment benefits offered as special termination benefits to employees shall be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. An employer that offers, for a short period of time, special termination benefits to employees, shall not recognize a loss at the date the offer is made based on the estimated acceptance rate."

In accordance with the abovementioned Codification, Targa Co. should record the termination benefits, severance costs, and terminated managers' bonus as a liability on the balance sheet and a loss upon the income statement when each employee accepts the offer. As the offer was distributed on December 27, 20X1, it is likely a small portion of the employees will accept before year-end, affecting year 20X1 statements, while the majority will accept in January of year 20X2.

Note that due to termination expected to be effective January 31, 20X2, paragraph 420-10-30-6 would not apply in this situation, as employees will be terminated before the required 60 days. If employees were retained over the 60 days, a liability would be recorded immediately and a loss would be recognized proportionally over the remaining time served.

B) Accounting for Retraining and Relocation Costs

FASB Codification 420-10-25-14 states:

"Other costs associated with an exit or disposal activity include, but are not limited to, costs to consolidate or close facilities and relocate employees."

FASB Codification 420-10-25-15 states:

"The liability shall not be recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan. A liability for other costs associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred (generally, when goods or services associated with the activity are received).

In accordance with the abovementioned rule, the liabilities involving relocation and retraining should not be recorded as such until the employee is relocated (relocation liability payable/expense) and trained (staff training liability payable/expense).

Case 8:

Merck & Co.

A) Consider Merck's common shares.

i. How many common shares is Merck authorized to issue?

5,400,000,000 shares

ii. How many common shares has Merck actually issued at December 31, 2007?

2,983.5 million shares

iii. Reconcile the number of shares issued at December 31, 2007, to the dollar value of common stock reported on the balance sheet.

$29,835.1 million shares

iv. How many common shares are held in treasury at December 31, 2007?

811 million shares

v. How many common shares are outstanding at December 31, 2007?

2,172.5 million shares

vi. At December 31, 2007, Merck's stock price closed at $57.61 per share. Calculate the total market capitalization of Merck on that day.

$125,157.9 million

C) Why do companies pay dividends on their common or ordinary shares? What normally happens to a company's share price when dividends are paid?

Companies pay dividends on their common shares as a return on the shareholders' investment. While it does vary with different cases, many times the share price will fall because declaring dividends might indicate to the market that the company has limited growth opportunities, especially with a young company.

D) In general, why do companies repurchase their own shares?

Companies repurchase their own shares because they believe their shares are undervalued on the market. Management is generally optimistic about the company's future when they repurchase stock, and they hope to realize a capital gain when the stock price rises.

E) Consider Merck's statement of cash flow and statement of retained earnings. Prepare a single entry that summarizes Merck's common dividend activity for 2007.

dr. Retained Earnings	3,310,700,000	
cr. Dividends Payable		3,400,000
cr. Cash		3,307,300,000

G) During 2007, Merck repurchased a number of its own common shares on the open market.

i. Describe the method Merck uses to account for its treasury stock transactions.

Merck uses the cost method to account for its treasury stock transactions. This means Merck put the treasury stock on their books at the market value at which they repurchased the shares.

ii. Refer to note 11 to Merck's financial statements. How many shares did Merck repurchase on the open market during 2007?

Merck repurchased 26.5 million shares during 2007.

iii. How much did Merck pay, in total and per share, on average, to buy back its stock during 2007? What type of cash flow does this represent?

Merck paid a total of $1,429.7 million ($53.95/share) to repurchase its stock in 2007. This represents a financing activity.

iv. Why doesn't Merck disclose its treasury stock as an asset?

Treasury stock is not an asset because while Merck can earn future cash benefits from the resale of this stock, it cannot realize an economic gain (increased net income) by investing in its own stock.

I)

	2007	**2006**
Dividends Paid	($3,307.3 million)	($3,322.6 million)
Shares Outstanding	2,172.5 million	2,167.8 million
Net Income	$3,275.4 million	$4,433.8 million
Total Assets	$48,350.7 million	$44,569.8 million
Operating Cash Flows	$6,999,200,000	$6,765,200,00
Year-End Stock Price	$57.61	$41.94
Dividends per Share	$1.52	$1.53
Dividend Yield	2.64%	3.65%
Dividend Payout	1.01	.75
Dividends to Total Assets	6.84%	7.45%
Dividends to Operating Cash Flows	47.25%	49.11%

Case 9:

Xilinx, Inc.

A)

A stock option incentive plan compensates employees with stock options, which expire at a specific date, instead of cash. Most incentive plans have a longer date until expiration in an attempt to motivate employees to not only stay with the company, but also motivate them to bring additional value to the company, which in turn will increase the employees' return on the option.

B)

While stock call options derive their value from the difference between market and exercise price, the restricted stock units derive their value from the exact market price. Using both of these as forms of compensation offers companies flexibility on how to pay their employees, depending on the predicted future market value of the company's stock.

C)

Grant date: The day an employee is awarded an option

Exercise price: The price per share the owner of an option can buy or sell a security

Vesting period: The time an employee must wait before exercising his/her options

Expiration date: The last day an option can be exercised

Options/RSUs granted: Options/RSUs given to an employee as compensation

Options exercised: Options that are used before the expiration date

Options/RSUs forfeited: Options that are not exercised before the expiration date

D)

In two-year periods, Xilinx's employee stock purchase plan allows employees to purchase stock every six months for 85% of the market value of the stock at the beginning of the two year period or the end of every six month increment, whichever is lower. This plan incentivizes employees by allowing them to have a personal stake in the company at a below market cost. Even employees inexperienced in investing may experience a capital gain by immediately reselling the stock on the market. It is different from RSUs and options because it has a shorter vesture period.

E)

Xilinx accounts for its stock-based compensation by recording the stock compensation in a paid-in-capital account at market value on the day the compensation was granted, and expensed over the vesting period over according to the services provided by the compensated employee. Because this transaction is recorded on the day granted instead of the day the option is exercised, there is an understatement of taxable income on the income statement, resulting in a deferred tax asset.

F)

i. $77,862

ii. This expense is recorded in the Cost of revenues; Research and development; and the Selling, general, and administrative accounts, depending on what service the employee compensated provided.

iii. The 2013 expense is an operating activity and is added back to Net Income in the statement of cash flows, as it was expensed but no cash ever changed hands thus understating the cash flow.

iv. While you can include the stock-based compensation expense in your financial statements net income, it cannot be included in taxable income until the options are exercised or expired. Because taxable income is higher than net income for 2013, you are paying more in taxes this year. This creates a tax benefit that will roll over to succeeding years, where net income will be higher than taxable income, as the stock-based compensation expense will then be recognized for taxable income. In essence, this benefit makes sure you are not taxed twice for the same expense.

v.

dr. Cost of Goods Sold	6,356	
dr. R&D Expense	37,937	
dr. SG&A Expense	33,569	
cr. Deferred Tax Asset		22,137
cr. APIC- Stock Options		55,725

I)

i. In recent years, companies have shifted drastically to granting restricted stock in lieu of stock options as the primary form of non-cash compensation. Companies prefer this plan because it brings more certainty than options to their employees, and the accounting for RSUs is much easier. Employees' preference will depend on how much risk an individual employee will accept. More risk-prone employees will prefer options, as they are worth nothing if the market is trading below the stock price, but they also provide the greatest opportunity for a large return. Employees who favor less risk would prefer restricted stock, as it has a guaranteed value, although it doesn't have as great a potential for a large return that options do.

ii. Xilinx's footnotes indicate that their stock-based compensation plan is consistent with the *Wall Street Journal* article. From 2010-2013, Xilinx's outstanding options dropped from 31,026 to 12,753 in only three years. During that same time period, the number of restricted shares outstanding rose from 3,652 to 5,996. These numbers indicate that Xilinx is shifting to a plan that favors RSUs instead of options.

Case 10:

Revenue Recognition

Part I

Step 1: Identify the contract with a customer:

A contract has been formed when the student orders a cup of beer, and the bartender says it will be $5.

Step 2: Identify the performance obligations in the contract:

The performance obligation for the Bier Haus is serving the college student a cup of beer.

Step 3: Determine the transaction price:

The transaction price is the $5 that the Bier Haus is entitled is exchange for fulfilling its performance obligations.

Step 4: Allocate the transaction price to the performance obligations in the contract:

There is only one transaction price and performance obligation, thus the $5 is allocated to the cup of beer.

Step 5: Recognize revenue when the entity satisfies a performance obligation:

Revenue is recognized as soon as the $5 is exchanged for the cup of beer.

Journal Entry:

dr. Cash	$5	
cr. Sales Revenue		$5

Part II

Step 1: Identify the contract with a customer:

A contract is formed when the student orders a large beer in an Ole Miss thermal beer mug.

Step 2: Identify the performance obligations in the contract:

The performance obligation for the Bier Haus is serving the college student a cup of beer in an Ole Miss thermal beer mug.

Step 3: Determine the transaction price:

The transaction price is the $7 that the Bier Haus is entitled is exchange for fulfilling its performance obligations.

Step 4: Allocate the transaction price to the performance obligations in the contract:

The stand-alone price for the thermal mug is $3, and the stand-alone price for the beer is $5. We allocate the transaction price to the performance obligations in proportion to the stand-alone prices and the sum of the stand-alone prices. Therefore, $2.63 ((3/8)*$7) should be allocated to the thermal mug, and $4.37 ((5/8)*$7) should be allocated to the beer.

Step 5: Recognize revenue when the entity satisfies a performance obligation:

Revenue is recognized as soon as the $7 is exchanged for the cup of beer and thermal mug.

Journal Entry:

dr. Cash	$7	
cr. Sales Revenue- Beer		$4.37
cr. Sales Revenue- Mug		$2.63

Part III

Step 1: Identify the contract with a customer:

A contract has been formed when the student accepts the bartender's counteroffer of a beer and coupon redeemable for two pretzels in exchange for $7.

Step 2: Identify the performance obligations in the contract:

The performance obligation for the Bier Haus is serving the college student a cup of beer and providing the student with a coupon redeemable for two pretzels.

Step 3: Determine the transaction price:

The transaction price is the $7 that the Bier Haus is entitled is exchange for fulfilling its performance obligations.

Step 4: Allocate the transaction price to the performance obligations in the contract:

The stand-alone price for the beer is $5, and the stand-alone price for the coupon is $3.50. We allocate the transaction price to the performance obligations in proportion to the stand-alone prices and the sum of the stand-alone prices. Therefore, $2.88 ((3.5/8.5)*$7) should be allocated to the coupon, and $4.12 ((5/8.5)*$7) should be allocated to the beer.

Step 5: Recognize revenue when the entity satisfies a performance obligation:

Revenue is recognized as soon as the $7 is exchanged for the cup of beer and coupon. You do not wait to recognize the coupon revenue because historically coupons have always been redeemed.

Journal Entry:

dr. Cash	$7	
cr. Sales Revenue-Beer		$4.12
cr. Unearned Sales Revenue- Coupon		$2.88

Part IV

Step 1: Identify the contract with a customer:

A contract has been formed after the bartender accepts the coupon as valid and therefore has an obligation to give the student two pretzels.

Step 2: Identify the performance obligations in the contract:

The performance obligation for the Bier Haus is serving the college student two pretzels.

Step 3: Determine the transaction price:

The transaction price is the retirement of the outstanding coupon.

Step 4: Allocate the transaction price to the performance obligations in the contract:

There is only one transaction price and performance obligation, thus the coupon retirement is allocated to the two pretzels.

Step 5: Recognize revenue when the entity satisfies a performance obligation:

Because Bier Haus's pretzel coupons have always been redeemed, they were able to record the revenue in week 3 when the coupon was purchased. Therefore, there is no additional revenue to be recognized following this transaction

Journal Entry:

dr. Cash	$5	
cr. Sales Revenue		$5

Case 11:

ZAGG Inc.

A) Book income is the net income that a corporation or business entity reports on its financial statements. ZAGG's book income for 2012 is $14,505,000. A company's book income differs from taxable income by the differences between revenue and expense recognition, as well as differences between the two reporting standards.

B)

Permanent tax differences: a business transaction that is reported differently for financial and tax reporting purposes, and for which the difference between the two will never be eliminated. Ex: Municipal bond interest revenue is recorded for financial purposes, but is tax exempt.

Temporary tax differences: a business transaction that is reported differently for financial and tax reporting purposes, but the difference between the two is settled in time. These differences are prominently caused by discrepancies in the financial and tax reporting standards. Ex: Differences in recording depreciation expense.

Statutory tax rate: tax percentage imposed by law

Effective tax rate: the percentage of income a business actually pays in taxes

C) A company generally reports deferred income taxes as part of their total income tax expense because of the differences in the standards of reporting. For example, companies will recognize revenue and expenses when they can reasonably expect said revenue and expenses will occur, however, for tax purposes, these revenues and expenses will not be recognized until cash has been paid.

D) A deferred tax asset occurs when a company's taxable income is greater than its book income. This causes the company to pay higher taxes for that given year and less for the following years. A deferred tax liability occurs when a company's taxable income is less than its book income, and subsequently the company owes taxes in the following years. Both of these are caused due to differences in the financial accounting and tax accounting standards. Suppose a company calculates its book income using straight-line depreciation, while taxable income is determined by using MACRS. The difference in depreciation expense will create a difference in income, and the result is either a DTA or a DTL, depending on which method creates a higher taxable income.

E) A deferred income tax valuation is an account that reduces the amount of a company or business entity's deferred tax assets because the company/business entity does not expect to realize the benefits of this tax asset. This account should be created when there is a 50%+ chance that the company will not realize the said asset. For example, this account would be created when a company expects its future profits to be inadequate enough that it will not be able to benefit from the deferred tax asset. In essence, the company's profits were never enough to offset the overpaid taxes.

F)

i.

dr. Income Tax Expense	9,393	
dr. Net Deferred Tax Asset	8,293	
cr. Income Tax Payable		17,686

ii.

dr. Income Tax Expense	9,393	
dr. Deferred Tax Asset	8,002	
dr. Deferred Tax Liability	292	
cr. Income Tax payable		17,686

iii.

Effective Tax Rate = 9,393/23,898 = 39.3%

iv.

This number is represented in current assets for the current portion of 6,912, and in the noncurrent portion assets for the noncurrent portion of 6,596. This helps represent to investors and creditors what the future tax effect will be on ZAGGS Inc. Financial statement users care about deferred income tax assets and liabilities, because, if large enough, the future financial statements can be materially affected.

Case 12:

Build-A-Bear

A)

Leasing, rather than purchasing, assets outright has some advantages compared to the latter. Two of the most beneficial aspects of leasing are that it puts less stress on a company's cash flows, and it has the tax benefit of being able to write off lease costs.

B)

Operating Lease: lease of an asset that does not meet the terms to qualify as a capital lease. Has the advantage of a company not having to report an asset on its balance sheet.

Capital Lease: lease in which all the ownership rights of the leased property are transferred to the lessee. In essence, capital leases act as a way for companies to finance a purchase

Direct-Financing Lease: lease where the asset is taken off of the lessor's books and replaced with a receivable. Income is recognized as the payments on this receivable come in, and the IRR is the difference between cash payments and the asset's book value.

Sales-Type Lease: lease where the fair value of the leased property at the start of a lease varies from its carrying amount, involves real estate, and there is a transfer of ownership to the lessee by the end of the lease term

C)

Each lease has a separate name because different leases are accounted for differently. Without separate classifications it would be hard to form financial statements that faithfully represented the company's actual position.

D)

i) This lease is an operating lease because ownership does not transfer at the end of the lease, there is no bargain purchase option, the lease term does not encompass 75% of the store's useful life, and the present value of the lease payments is not 90% of the store's fair value.

ii)

Dr. Lease Expense	100,000	
Cr. Cash		100,000

iii)

<u>First Year</u>

Dr. Lease Expense	100,000	
Cr. Deferred Rent		100,000

<u>Second-Fifth Year</u>

Dr. Lease Expense	100,000	
Dr. Deferred Rent	25,000	
Cr. Cash		125,000

E)

i) In 2009, Build-A-Bear had a total operating lease expense of $46.7 million dollars, which consisted of base rent of $45.9 million and $.9 million of additional contingent rent expense.

ii) This amount appeared in the operating expense account on the income statement.

F)

i)

Period	Payment	PV factor	Present Value
1	50,651	0.9346	$47,337.38
2	47,107	0.8734	$41,145.08
3	42,345	0.8163	$34,566.13
4	35,469	0.7629	$27,059.13
5	31,319	0.7130	$22,330.01
6	25,229	0.6663	$16,811.15
7	25,229	0.6227	$15,711.35
8	25,229	0.5820	$14,683.51
		PV of PMTs=	$219,643.75

ii)

Dr. Property and Equipment	$219,644	
Cr. Lease Liability		219,644

v.

Dr. Lease Liability	35,276	
Dr. Interest Expense	15,375	
Cr. Cash		50,651
Dr. Depreciation Expense	27,455	
Cr. Accumulated Depreciation		27,455

G)

Under current GAAP, Build-A-Bear is incentivized to structure its leases as operating leases because by doing this, the company is able to deduct its lease payments for each year on that year's income statement. By lowering its net income, the company decreases its tax expense. This effect does not jeopardize the quality of the company's financial reporting, but if the company structured this lease as a capital lease, capital assets on the balance sheet and net income would both be higher.

H)

If Build-A-Bear capitalized its operating leases, the current ratio, debt-to-equity ratio, and long-term debt-to-total assets ratio would all be affected. The current ratio would decrease. This is because, as seen in section F part V above, the current portion of the lease liability is less than the cash outflow for the period. The debt-to-equity ratio would increase, as Build-A-Bear is recording a large lease liability when capitalizing the lease (also seen above). The long-term debt-to-total assets would first remain unchanged, as the debt and assets increase by the same amount upon capitalization, but would slowly increase, as the amortization of the capital lease is slower than the cash outflow and depreciation.